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The Customization Effect of Pre-arranged Sales under Anglo-American Insolvency Law and Practice: Accountability Deficits and Possible Remedies

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Abstract:

A strong paradox is emerging on both sides of the Atlantic when it comes to pre-arranged sales of troubled businesses as a going concern in an insolvency procedure. While tons of ink have been shed to explain distinctive features and comparative advantages of out-of-court and formal (court-sanctioned) restructurings these days there is an increasing trend to employ both with a view to achieve optimal outcomes. The accelerated judicial approach to business sales plaits the informal approach and the state-controlled statutory approach of dealing with corporate distress. This article investigates the extent to which formal insolvency procedures in the UK and the USA can be customized through pre-planning to achieve business sales and critically evaluates the challenges brought about by the plaiting. It is argued that the accelerated approach to business sales in insolvency tends to shift the key properties of the statutory procedure from creditor coordination and plan formulation towards verification of pre-arranged transactions and in doing so it obviates the need for judicial involvement. This way it creates a vacuum of control over the quality of business decision–making and eliminates the inclusiveness of the statutory procedure leaving ample room for rent-seeking by insiders. To mitigate these deficiencies the article suggests a more responsive approach with increased accountability and better equipped evaluation to control abuse.

Key words: Accelerated business sales; pre-packs; section 363(b) sales

A Introduction

The most important recent development in contemporary insolvency law and practice is a marked shift from liquidation and creditor wealth maximisation to corporate rescue and value preservation. Insolvency laws in mature jurisdictions have developed rescue-oriented procedures to facilitate that goal. Most of those rescue-oriented procedures are premised on the notion that keeping the business and the assets together will result in increase in value over what could be obtained in liquidation. Therefore, at least in theory, the rescue process is all about preserving the so-called "going concern" surplus[1] of those businesses that may be financially distressed yet are still economically viable or efficient. Conversely the liquidation process is better suited to those businesses that are economically unviable,[2] freeing up resources to be invested to new business ventures in the economy.

The going-concern surplus can be captured by a successful turnaround of the distressed company, which leads to the preservation of the legal entity itself so that the company can continue operations after reorganization, i.e. company rescue, or by the sale of the debtor's assets and business as a going concern so that the actual business and its activities will remain as a cohesive productive unit but under a new ownership, i.e. business rescue.[3] Legislation leaves it to affected parties to decide

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[1] It refers to the surplus (additional value) that is believed to be generated by the sale of the business as whole as compared to the sale of the firm's assets in a piecemeal fashion. Namely, the going concern value could be measured by estimating the income stream that the assets would generate if they were kept together, taking into account the risk of reorganisation failure and comparing it to the amount that the assets would realise if they were sold off separately. See G McCormack, *Corporate Rescue Law: An Anglo-American Perspective*, (Edward Elgar, Cheltenham 2008), 3. DG Baird and TH Jackson, 'Corporate Reorganisation and the Treatment of Diverse Ownership Interests: A Comment of Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97, 109. See also TH Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, Harvard 1986), 184.

[2] Michelle White opined that the economically inefficient companies are those whose resources would be more valuable in some alternative use; whereas the resources in the economically efficient companies have no higher value use elsewhere despite their financial distress. See M J White, 'Does Chapter 11 Save Economically Inefficient Firms?' 72 (1994) *Washington University Law Review* 3 1319, 1319. However, it is empirically difficult to distinguish financial and economic distress. It is often not obvious whether a troubled company in financial difficulty is still economically viable or not and the judgement varies among different parties due to their possession of information about the company and their private interests.

[3] The analysis will not discuss the assumption/ premise whether going concern value is preserved in the sale. For discussions on going concern surplus, see DG Baird and RK Rasmussen, 'The End of Bankruptcy' (2002) 55 *Stanford Law Review* 751, 758. RV Butler and SM Gilpatric, 'A Re-Examination of the Purposes and Goals of Bankruptcy' (1994) 2 *American Bankruptcy Institute Law Review* 269.

(through the various voting mechanisms) the best option for value preservation which is then affirmed through formal procedures.

Interestingly, the use of insolvency proceedings to sell a business as a going concern to new owners as a means of resolving distress has increased dramatically in recent years at the expense of the traditional company rescue approach. In particular, achieving going concern sales through a formal insolvency procedure in an expedited manner has gained considerable popularity in insolvency practice both in the UK and the USA in the last two decades. Many distressed companies have been pushed to conduct a business sale as a result of a mixture of a difficult trade environment and tight credit conditions during the post-2008 financial turmoil and ensuing economic slowdown. These conditions included inability to obtain new bank loans to refinance existing debt, lack of trade orders, and lack of investors willing to offer fresh capital. At the same time, rapid changes have been observed in corporate finance practice with the emergence of hedge funds and private equity groups as important players replacing in some areas traditional commercial banks as sources of capital.[4]

Achieving going concern sales through a formal insolvency procedure is often conducted in an expedited manner. In the USA, business sales can be part of a formal plan of Chapter 11 reorganization, but more often they are undertaken using a special section of the U.S. Bankruptcy Code – Section 363(b) – that can greatly facilitate these sales in an expedited manner ("section 363 sales").[5] In the UK, going-concern sales are often conducted through the so called "pre-packaged administration" process ("pre-packs"), where arrangements of a sale of a distressed business have been negotiated with prospective purchasers and agreed by the major creditors[6] prior to the commencement of the administration procedure, with the sale being completed fairly quickly after the appointment of an administrator.[7] Both the US section 363 sales and

[4] DG Baird and RK Rasmussen, 'Anti-Bankruptcy' (2010) 120 *Yale Law Journal* 648, 659.

[5] In practice, s 363 sales are the preferred method of selling assets in the context of Chapter 11 bankruptcy cases. See Fishman and Gouveia, 'What's Driving Section 363 Sales after Chrysler and General Motors?' (2010) 19 *Norton Journal of Bankruptcy Law and Practice* 351, 352.

[6] This paper uses the expression "major creditors", as shorthand for the parties which could exert some degree of influence on the disposal process, including the senior secured bank creditors, significant trade creditors or bondholders.

[7] No formal definition of "pre-packs" or of similar strategies appears within the UK insolvency statutes. The key difference between pre-packs and business sales within the boundaries of

the UK pre-pack sales take a similar form of fast-tracking formal insolvency procedures to achieve value realization through going concern disposals.

Such accelerated routes for business sales in insolvency essentially present an innovative approach to overcome the hold-out problem in contractual informal workouts whereby entering a formal procedure helps to solidify the outcome of private negotiations, at the same time, to overcome the anti-commons problem associated with the statutory approach by developing a more market-driven decision-making apparatus than the one found in the formal insolvency procedures. It therefore plaits both formal (state-supplied) and private workout approaches in solving corporate distress. This article uses the term “plaiting” to refer to this approach.

This form of plaiting allows certain parties to customize statutory procedures in a way that upsets, to some extent, the balance between the debtor and some creditors and challenges the inclusiveness of the statutory procedures. This article investigates the extent to which formal insolvency procedures in the UK and the USA can be customized through pre-planning to achieve business sales and critically examines the challenges brought about by the plaiting. The article argues that this approach tends to obviate the need for judicial involvement in business decision-making and the functions of statutory procedure (or state rules) are moving away from creditor coordination and plan formulation towards verification of pre-arranged transactions. While the plaiting approach may be a sound solution to the commons-anti-commons dilemma and might be the only sound route when the value of the company subject to the pre-arranged sale risks suffering the “ice-cube” effect, the customization may create a vacuum of control over the quality of the business decision-making process at the pre-formal stage. To mitigate these deficiencies, the article argues that a new balance must be struck between procedural efficiency and protection of creditor interests by means of appropriate valuation mechanisms. Also the accountability of the decision-making and enforcement institutions should be enhanced, since their role is to examine and verify, in a speedy way, compliance with legal requirements, rather than acting as rubber-stabbing bodies as currently seems to be the case.

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administration is that the pre-pack sale is arranged before the appointment of administrator and outside the administration procedure.

The article is divided into 5 sections with the present introduction. Section B sets the stage for comparison and analysis by examining the rationale and approaches to allocation of decision-making authority in the statutory rescue regimes of the UK and the USA. Section C critically analyzes the respective approaches to pre-arranged expedited sales in UK and USA insolvency law and practice. It will highlight the extent to which parties can customize formal bankruptcy procedures through pre-planning to achieve expedited sales. This is to show how the pressure to buttress pre-arranged deals has been accommodated or perverted in the surveyed insolvency regimes. Section D considers different approaches in dealing with the intensified tension between procedural efficiency and creditor protection in the two jurisdictions and offers arguments in favour of increased formal control and accountability in decision-making. Section E concludes.

B. The commons, anti-commons problem in insolvency and the rise of pre-arranged business sales

Corporate debt may be worked out privately following debtor/creditor negotiations or by way of a formal filing which will trigger the initiation of an insolvency procedure and the ensuing deployment of state-supplied rules to address corporate distress. Private workouts follow a contractual approach whereby parties have broader discretion to choose the rules that will govern their relationship and contract around those rules. In contrast, the state-supplied approach is designed under insolvency legislation so that the parties are subject to more elaborately drawn rules which impose stronger restrictions on their conduct.[8] It allows compromises and arrangements for debt restructuring to be made under the supervision of the court or a formal legal structure.

In private workouts, creditors' consent is essential to effectuate a workout and every creditor would have to credibly commit to not enforcing his individual rights by

[8] JC Lipson, 'Against Regulatory Displacement: an Institutional Analysis of Financial Crises' (2015) 17 *University of Pennsylvania Journal of Business Law* 673, 700.

vetoing a workout for strategic reasons.[9] Sophisticated creditors may be tempted to hold out for a better deal. This behavior can frustrate any private rescue attempt to the detriment of a potential going concern surplus. Baird and Jackson present this situation in their creditors' bargaining model that is based on the common pool metaphor and which leads to 'prisoner's dilemma' situations when exercising individual debt collection remedies against the defaulting debtor.[10]

The contractual approach is widely regarded as incapable to deal with strategic bargaining and the hold-out problem, and therefore the coordination cost could be high. Thus, from an economic analysis perspective the imposition of state-supplied insolvency rules can address coordination problems, i.e., the near impossibility of contracting among the diverse parties with an interest in the debtor's assets,[11] and other market failures that are normally present in private workouts when addressing the common pool problem.[12] Accordingly, insolvency law should be primarily understood as a collective procedure seeking to overcome destructive asset grabbing. To combat the common pool problems, statutory proceedings impose a comprehensive moratorium on individual enforcement rights and lock all creditors into a collective procedure.[13] In augmenting this approach state-supplied rules further resolve the commons problem by allowing a majority of those whose interests are at

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[9] On the commons problems in private workouts, see R de Weijs, Harmonization of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool and Anticommons (Centre for the Study of European Contract Law Working Paper No 16, 2011), J Armour and S Deakin, 'Norms in Private Insolvency: The 'London Approach' to the Resolution of Financial Distress' (2001) 1 *Journal of Corporate Law Studies* 21-51. See also M Schillig, 'Corporate Insolvency Law in the Twenty First Century: State Imposed or Market Based? (2014) 14 *Journal of Corporate Law Studies* 1, 6-9.

[10] MJ Roe, 'The voting prohibition in Bond Workout' (1987) 97 *Yale Law Journal* 232, 235-238. See also R Gertner and D Scharfstein, 'A Theory of Workouts and the Effects of Reorganization law' (1991) 46 *The Journal of Finance* 1189, 1200-1201.

[11] TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' 91 (1982) *Yale Law Journal* 857, 866-67.

[12] The common pool problem is a race of the creditors on the debtor's assets in a commons situation where too many individual enforcement rights resulting in a premature liquidation of the debtor company.

[13] Schillig, 'Corporate Insolvency Law in the Twenty First Century: State Imposed or Market Based?, 3. See also TH Jackson, The Logic and Limits of Bankruptcy Law (Harvard University Press, Harvard 1986), 122.

stake to agree on whether a proposed plan should be accepted or not preventing individual creditors from engaging in 'hold-up' tactics.[14]

Notwithstanding the benefit of collective statutory proceedings in minimizing coordination problems and costs in insolvency, the formal collective approach appears limited when accommodating business sales as an option for value preservation in appropriate circumstances. On the one hand, insolvency legislation provides various mechanisms whereby compromises and arrangements can be made under the supervision or necessary restraints of legislative contemplations.[15] For the purpose of providing adequate protection for various groups of creditors, as well as checks and balances on the conflicting incentives held by different stakeholders, the legal proceedings often involve complicated accountability requirements and rounds of negotiations to conclude the approval of a rescue plan. This makes the formal approach a complex process that is both lengthy and costly.

One the other hand, rescue-oriented statutory procedures are often designed on the presumption that maximum of value of the pool would be achieved through a successful rescue of the falling company. But reality suggests that there only is a very remote possibility of saving the company where the debts are cripplingly high when companies are put in the statutory procedures. Value maximization of the asset pool often depends upon the timeline of critical decision-making and execution. The longer the problem the fewer options become available and the further deterioration in value, especially those in emergency situations where speed is crucial for preserving the value of the company' assets.

[14] Minority dissenters in the legal proceedings are therefore bound to the deal the majority prefer in order to avoid inefficient holdout behaviour.

[15] For instance, a creditors' meeting will be convened within a practically reasonable period; the reorganisation plan needs to be accepted by the majority of the allowed claims. Under English administration procedure, the administrator's proposals are passed when support is obtained from a majority in value of those present and voting creditors, either in person or by proxy. In the US, claims and interests are dealt with by classes, specifying unimpaired and impaired classes. A plan is deemed to be accepted when at least two-thirds of votes and more than one-half in number of allowed claims of each voting class of creditors, and two-thirds in amount of the shares for a class of equity interests, have accepted it.

The anti-commons problem[16] becomes even more acute because the statutory procedures tend be quite slow when time may be a clear factor in the preservation of the going concern surplus which delay and uncertainty in reaching critical decisions can undermine. Clearly the potential economic disruption generated by the length of proceedings gives claimholders the incentive to look for alternative restructuring strategies.

Both the UK pre-pack sales and the US section 363 sales are fast-track procedures that aim at facilitating business rescue through going-concern sales. Namely, they aim at maximizing value realization through going concern disposals. Section 363 allows substantial asset sales to be implemented prior to the confirmation of a Chapter 11 plan and therefore much faster and at a much lower procedural cost than a sale effected as part of a plan of reorganization.[17] Similarly, by privately pre-arranging a deal before the company is put into administration, the UK pre-pack sales help the parties to circumvent possibly time-consuming and expensive administration proceedings. Therefore, the pre-arranged sale process offers an attractive and streamlined process that is capable to maximize value realization by permitting a timely disposal of the failing business and, thus, salvaging the worthwhile parts of the company that might otherwise have been jeopardized by the uncertainty and costs of lengthy formal proceedings.

Despite these clear advantages, the accelerated approach of going concern sales in insolvency is at the same time fraught with controversy. First, the increasing

[16] The term “anti-commons” is a shorthand for a broad class of problems requiring the assembly of permissions or entitlements accompanied with the worry “that a value-enhancing assembly – one that could leave every party better off than the status quo – will fail to occur as a result of strategic holdout behavior and other transaction costs. Like the tragedy of the commons, the tragedy of the anti-commons makes inefficiency transparent by creating a self-contained system in which participants make themselves worse off.” See LA Fennell, ‘Commons, anticommons, semicommons’ in K Ayotte and HE Smith (edt) *Research Handbook on the Economics of Property Law* (Edward Elgar 2011), 41.

[17] S 363 sales are typically completed within two to three months, whereas creditor confirmation of a reorganization plan may span several years. For example, the sales of *General Motors* and *Chrysler* businesses under s 363 took forty and forty-two days respectively prove this point. See RE Steinberg, ‘Seven Deadly Sins in S 363 Sales’ (2005) 24 *American Bankruptcy Institute Journal* 22, 22. In contrast, plan confirmation requires compliance with all of the detailed confirmation requirements under s 1129 of the Code, including approval of a disclosure statement and successful solicitation and voting on the plan.

popularity of pre-arranged sales in insolvency in both countries has led to concerns that the statutory procedures have shifted toward excessive premature liquidation of financially distressed companies.[18] In the US, concerns have been raised that this trend may lead market mechanisms to dominate the new speedier Chapter 11 procedure which relies heavily on asset sales and arrangements negotiated prior to bankruptcy.[19] In the UK, critics have expressed concerns about the fact that pre-pack deals are often determined at the beginning of the deliberation process when a solution is sought to the company's financial distress. Namely, that they have become the default solution, neglecting the statutory requirement to consider rescuing the company, as the administrator, when appointed at a late stage, has no opportunity to consider thoroughly the possible routes to rescuing the company.[20]

These concerns highlight the commons anti-commons dilemma in corporate rescue. On the one hand, a collective action prescribed by the statute is needed to overcome difficulties in coalition formation by prescribing claimants a clear order of preference as well as a fair opportunity to participate in the aggregative pool of assets enabling them to be treated according to the size and seniority of their claims. On the other hand, when it comes to value presentation, privatisation of formal rules has been advocated, especially in connection to the decisions over business issues. The key argument here is that the state-supplied rules often vest decision-making authority in the hands of parties such as judges or authorized court officers who may not particularly well equipped to decide on business matters, given that resolution of

[18] Over the past decade, this debate has become increasingly relevant in the USA, where it has been suggested that asset sales have come to replace traditional reorganization as the primary means of resolving financial distress. See Baird and Rasmussen, 'The End of Bankruptcy' (describing a fundamental shift in chapter 11 bankruptcy from a reorganisation vehicle to a means of liquidation driven in large part by secured creditors who increasingly view the sales value of a firm's current assets ass greater than the going-concern value of those assets in the future). Baird and Rasmussen (2002) speculate that "corporate reorganizations have all but disappeared." JC Lipson and C Divirgilio, 'Controlling the Market for Information in Reorganisation, (2010) 18 *American Bankruptcy Institution Law Journal* 647. They note that "[i]nstead of providing a substitute for a market sale, Chapter 11 now serves as the forum where such sales are conducted." Id. 653.

[19] S Franken, 'Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited' (2004) 5 European Business Organization Law Review 645, 668. See further Baird and Rasmussen, 'The End of Bankruptcy', 786-8; DG Baird, 'Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations', (2001) 87 *Virginia Law Review* 921, 941. Cf LM LoPucki, 'The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy', (2003) 56 *Stanford Law Review* 645, 670-1 (stating that empirical data shows that reorganization is still an important reason for large publicly held companies to file for bankruptcy).

[20] P Walton, 'Pre-Packaged Administrations - Trick or Treat' (2006) 19 *Insolvency Intelligence* 113, 115-16.

financial distress involves high degrees of uncertainty and creativity best addressed through both informal and formal mechanisms.[21]

The next section will examine closely the plaiting approach that enabled pre-arranged sales in the UK and the USA. It questions whether plaiting remedies the commons anti-commons dilemma with a view of value preservation and highlighting the effect on vacuuming control over the quality of commercial decision-making in the process.

C. Charting an accelerated route for business sales in insolvency–Critical Analysis of the UK and US approaches

At this point it should be noted that the UK and the USA take different governance approaches in buttressing insolvency law functions. Chapter 11 of the US Bankruptcy Code is, in principle, a bargaining-oriented procedure in the sense that its emphasis is on classes of claimholders working to resolve their differences through a process of bargaining and negotiation to come up with a reorganization plan under the court's supervision and intervention.[22] In doing so, the US approach operates on the debtor-in-possession (DIP) principle, which allows companies' incumbent management to remain in office and run the business in the ordinary way during the reorganization process with the exclusive power in drafting the reorganization plan.[23] At the same time, Chapter 11 includes multiple mechanisms designed to supervise the DIP.[24] Furthermore, the US bankruptcy law has premised its governance structure on a regulatory system that attracts much intervention from the bankruptcy courts, which play a central role in evaluating the feasibility of the plan and in general ensuring an effective operation of the legal framework. By contrast, the UK administration procedure takes a professional-led discretionary approach in the governance of the case, under which directors of the troubled company are required to transfer their control of the company to an external insolvency practitioner as soon as the statutory procedure is triggered. The UK law envisages that the administrator is suitably

[21] JC Lipson, 'Against Regulatory Displacement: an Institutional Analysis of Financial Crises' (2015) 17 *University of Pennsylvania Journal of Business Law* 673, 700.
[22] McCormack, *Corporate Rescue Law: An Anglo-American Perspective*, 115-16.
[23] For the relative merits of the US DIP model and the British PIP model, see D Hahn, 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 *Journal of Corporate Law Studies* 117. V Finch, "Control and Co-ordination in Corporate Rescue" (2005) 25 *Legal Studies* 374.
[24] Those mechanisms include a mandatory creditors' committee, designed to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business and any other matter relevant to the case or to the formulation of a plan…" see 11 USC s 1103(c)(2).

qualified and once appointed is free to act with a considerable breadth of discretion without court involvement, except where directions are sought.[25]

1. Pre-pack Sales in the UK

(a) Customising the Administration Procedure through Pre-packing

Conventionally, once the company is put into administration, the coordination and control of the company's affairs are concentrated in the hands of the administrator, who is vested with extensive powers to do anything necessary for the management of the affairs, business and property of the company. These powers extend to selling a substantial part of the business as a going concern.[26] Having reviewed the company's business and affairs, the administrator must set out his proposals for achieving the purpose of the administration and put them together in a statement. He will then initiate a creditors' meeting to allow those who will be principally affected by the implementation of the plan, mainly unsecured creditors,[27] to vote on the proposals put forward, subject to certain exceptions.[28]

The UK administration procedure is multi-faceted. This is manifested by its provision for a hierarchical list of possible objectives for the procedure. Paragraph 3 of Schedule B1 to the IA 1986 lists three statutory objectives arranged in descending order for administrators to pursue,[29] at the same time provides a set of instructions

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[25] Administrators may apply to the court for directions in connection with his functions, but mainly for serious legal or procedural problems. Para. 63 of Sch. B1 to the IA 1986.

[26] Para.59(1) of Sch.B1 to the IA 1986.

[27] Para.73(1)(a) of Sch. B1 to the IA 1986 provides that the administrator's proposals cannot affect the rights of a secured creditor to enforce its security. Therefore, normally, only unsecured creditors are entitled to vote on the proposals. Secured creditors are only entitled to vote where their claim exceeds the value of their security. See R.2.40(1) IR 1986. They are, however, entitled to vote in respect of the full value of their claims if the meeting is required under para.52(2) of Sch. B1.

[28] A resolution on the administrator's proposal requires only overall majority in value of the debts owed to those present or voting. See R 2.42(1), (2) IR 1986.

[29] Para. 3 (1)

(a) rescuing the company as a going concern, or

(b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or

(c) realising property in order to make a distribution to one or more secured or preferential creditors.

about how the administrator should decide which objective to pursue.[30] Apparently, rescuing the distressed company is the prioritized objective of administration.[31] Notwithstanding this assertion a rescue decision in administration is subject to the statutory conditions that rescue is reasonably practical to achieve and would attain a better result for the company's creditors.[32] Nevertheless, neither of the conditions is often satisfied. This is because companies usually arrive at administration after the debtor has explored possible debt restructuring solutions informally with relevant creditors, and those efforts normally begin and fail prior to the triggering the statutory approach, at which point either the company is in dire straits, or a possible solution has been found and pursued to some degree. In such a case the administrator may decide that a going concern sale is the best way forward.[33]

There are two ways to achieve business sales through an administration in the UK: business sales within administration and pre-packaged sales. Understandably, a business sale within administration may also involve a certain degree of planning activities such as information gathering taking place before the appointment of the administrator. Yet the main decisions (to whom to sell, at what price) and proceedings are driven by consideration and assessment that follows the appointment of the administrator.[34] A pre-pack, in contrast, is essentially a pre-determined contractual arrangement.[35] The critical factor that distinguishes a pre-pack sale from a business sale within administration is that the details of the sale have been almost irrevocably arranged prior to the official appointment of the administrator.[36] As the substantial work of how to deal with the company is carried out at the pre-formal stage, little is left to be arranged in the context of the statutory procedure, apart from agreeing on administrator remuneration and distribution.

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[30] Only if he thinks that particular circumstances defined in the statutes are present, can he descend a step through the statutory hierarchy and consider the next possible objective. The statute further provides some criteria for selecting from the three objectives. See para. 3(2),(3),(4).

[31] The emphasis on company rescue of the revised UK administration regime is modest. That is to say that an administrator is obliged to pursue a going concern sale where he thinks this is the best course for the interests of the creditors as a whole, even where it might be possible to rescue the company.

[32] Para. 3(3) of Sch. B1 to the IA 1986.

[33] The rationale behind the sale is often justified on the basis that selling a business as a going concern is likely to realise more value than on a break-up sale of assets.

[34] S Frisby, *A Preliminary Analysis of Pre-Packaged Administrations (*Report to R3, 2007), 9.

[35] *Ibid.*, 11.

[36] *Ibid.,* 9. See also Walton, 'Pre-Packaged Administrations – Trick or Treat', 115–16.

If it is right to say that the administration procedure was originally contemplated to create a supportive platform in which administrators play a key role in evaluating all possible options, aiming to achieve an optimal outcome for creditors as a whole, the pre-packaged version of the process challenges this traditional contemplation about the statutory procedure. The role of the administrator in business decision-making is now partially discharged by the debtor's incumbent management. Namely, the focus of the insolvency decision-making in the pre-pack framework is on the pre-formal negotiation stage. Insolvency practitioners' role at this stage is considerably constrained by the timing of their involvement and the role they played at the pre-formal stage.[37] Clearly it is the incumbent management who are likely to play the determining part in the pre-administration negotiations since management retains extensive decision-making control over the company at this stage through residual managerial powers.[38]

Once the statutory procedure has been triggered and administrators have been appointed to effectuate the pre-determined business sale, administrators must use their commercial judgement on whether the pre-negotiated arrangements to sell the business in a way that has attracted the best price is practically achievable.[39] While administrators' decisions are subject to the rationality test,[40] they have broad discretion in verifying the pre-negotiated arrangements.

Arguably, the UK pre-pack administration goes half-way towards the US DIP governance model, as it allows a market-driven transfer of functions from the

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[37] B Xie, *Comparative Insolvency Law: the Pre-pack Approach in Corporate Rescue* (Edward Elgar, Cheltenham 2016), 78

[38] This is different from the institutional arrangements of the statutory procedure which contemplate that the powers of the directors are considerably curtailed by the administrator's appointment, though the appointment does not in itself affect the status of a director as such. Still the directors cannot exercise management powers which could interfere with the exercise of the administrator's duties and competences, see Para.64 of Sch. B1 to the IA 1986. Furthermore, they have a duty to co-operate with the administrator; breach of this duty by company directors may lead to their disqualification. S 235 IA 1986 and ss 6 and 9 of Company Directors Disqualification Act 1986. Also, the administrator has the power remove and appoint a director of the company. Para.61 of Sch. B1 to the IA 1986.

[39] See R J Mokal, *Corporate Insolvency Law: Theory and Application* (OUP, Oxford 2005), 237. The word 'thinks' in para. 3 of Schedule B1 means that the administrator will have to reach a considered view [about which objective to pursue]. See Hansard HL vol 633 cols 569-70 (10 April 2002).

[40] The basic formulation of the rationality requirement is that the administrator must not act in a way in which no reasonable administrator would act in the particular circumstances of a case. Lightman *et al.*, *The Law of Administrators and Receivers of Companies*, 246. See related cases *Re Edennote Ltd, Tottenham Hotspur plc and others v Ryman and another* [1996] 2 BCLC 239; *Edge v Pensions Ombudsman* [2000] Ch 602.

administrator to the existing management, especially with respect to control over the sale, at least the decision to sell.[41] Therefore, the role of the administrator as representative of the interests of the creditors as a whole is significantly weakened.

(b) Problems with the weakened role of Administrators in pre-pack sales

The reduction of the administrator's role goes against the logic behind the statutory procedure. The latter envisages that the legal rights of enforcing private contracts are taken away and replaced by the independent administrator's function who is granted central power to coordinate the process to achieve an optimal outcome for creditors as a whole. And as this central power is emptied an anti-commons problems arises. On the other hand, the adequacy of the sale price would go a long way in alleviating the anti-commons problem for creditors. Yet in practice there are considerable doubts as to whether the best possible sale price is achieved and whether the current safeguards are sufficient to secure such an outcome.

First, the ideal way to sell a business usually is to dispose of it at market value, which normally can be identified through an extensive process of advertising the business to the relevant interests. Owing to the (sometimes inevitably) expeditious nature of the pre-pack process, businesses are rarely marketed broadly. This means that potentially interested buyers stay essentially in the dark about the possibility of acquiring the business unless they follow their "hunch" and make unsolicited enquiries themselves. This restricted marketing inevitably has an effect on the pricing of the business to be disposed of. Arguably, for reasons that have to do with confidentiality, continuity of business, business reputation and the effect that any sale negotiations can have on the company's suppliers and customers, it may be very hard to hold a public auction for a distressed company or its assets. But this casts serious doubt on whether the best possible price for the sale of the business could ever be secured without marketing to attract potential purchasers.[42]

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[41] Xie, *Comparative Insolvency Law: the Pre-pack Approach in Corporate Rescue*, 228.

[42] B Xie, "Protecting the Interests of General Unsecured Creditors in Pre-packs: The Implication and Implementation of SIP 16" (2010) 31 *Company Lawyer* 189,194. M Crystal QC and R Mokal, 'The Valuation of Distressed Companies – a Conceptual Framework' (2006) BEPRESS Legal Series Working Paper 1370, 3.

Furthermore, the high frequency of pre-pack sales to a connected party, which may be the directors of the troubled company, the company's major shareholder or a company that is controlled or has a certain relationship with the directors or the major creditors or shareholders of the ailing company,[43] has only intensified concerns about the possibility of undervalued sales. Not unreasonably insiders are expected to take advantage of information gained through their position to further their own ends in the transaction.[44] The most common way to achieve this would be withholding essential information or not making reasonable efforts to promote competing bids, including carrying out little or no marketing of the business to non-connected parties. This way insider's rents are maximized instead of the sale price, prejudicing the size of creditors' payouts.

The remedy to this situation is far from obvious. For example involving administrators with negotiations occurring before their appointment risks compromising the independence of the insolvency practitioner. This is an important concern as the same administrator may coordinate the statutory procedure once his appointment is fixed in a manner that serves the preferences of powerful players,[45] given also directors' ability to appoint administrators out of court.[46] Credible research has shown that directors formally influence who is appointed in the majority of

[43] Insolvency Service statistics in its report on the operation of SIP 16 show that 73% of pre-pack sales during 2013 were to parties connected with the insolvent company, 79% of pre-pack sales during 2011; for 2010, the figure was 72%. The Insolvency Service, *2013 Annual Review of Insolvency Practitioner Regulation* (April 2014), 10. The figure for the first 6 months of 2012 was 69% of pre-packs. See The Insolvency Service, *2012 Annual Review of Insolvency Practitioner Regulation* (June 2013), 4. The Insolvency Service, *Report on the Operation of Statement of Insolvency Practice 16: 1 January to 31 December 2011*, 11. For the first six months of 2009, the figure was 81%. The Insolvency Service, *Report on the Operation of Statement of Insolvency Practice 16: July – December 2009*, 14.

[44] They may be aware of "soft" information about the business's viability, future prospects, which is not yet sufficiently precise to be included in any documentation.

[45] There is a worry that "the advisor may have been too aligned with certain interests –which may be those of well-placed creditors or involved managers." V Finch, 'Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains' (2006) Sep *Journal of Business Law* 568 574. See also V Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd Edn, CUP, Cambridge 2009) 471-72.

[46] Under the Enterprise Act 2002, the holder of a qualifying floating charge, the company, and the directors may appoint an administrator out of court. Appointment by the company or the directors is subjected to the approval of any person entitled to appoint an administrative receiver or any person who is or may be entitled to appoint an administrator under para.14. See paras.14, 22, 25 and 26 of Sch. B1 to Insolvency Act 1986.

administration cases[47] and this arguably makes it much harder to keep administrators shielded from undue directorial influence. When directors are considering appointing an administrator, they will discuss the different rescue scenarios with potential candidates. The directors are likely to appoint an insolvency practitioner who is willing to apply a 'practical' and 'cooperative' approach, or worse someone they think to be amenable to their preferences in handling the insolvency of the business.

Moreover, with regard to the issue of marketing of the sale, even if we are to assume that confidentiality and reputation concerns would limit the circle of potential buyers who could be sounded to buy the business this may not be an obstacle *per se* to achieving a competitive price. Discount funds and potential trade buyers from the same industry would still have an interest in acquiring a company in distress or its assets. In any case even within the aforementioned limitations a serious effort must be expended to identify and attract potential purchasers and generate competing bids. The fact that often most of the marketing effort takes place before the appointment of an administrator[48] and is mainly carried out by incumbent management inevitably gives rise to an atmosphere of doubt and suspicion as to how competitive was the process through which a sale price has been arrived at. Moreover, even if directors did have an incentive to seek competitive price buyers might encounter a "market for lemons" situation.[49] Namely, in the face of severe information asymmetries potential buyers would equally mistrust scrupulous and unscrupulous sellers and thus discount

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[47] According to the OFT's study, 75% of the 500 administration records in Companies House starting in 2006 are director- led appointments. 13% were directly appointed by secured creditors. See OFT, *The Market for Corporate Insolvency Practitioner – a Market Study* (OFT1245, June 2010), para. 4.5 and ft 35. Although it remains unclear what is the corresponding statistic in pre-pack cases, a predominance of director-led appointments is likely to be the case for pre-packs too. It should be noted that many of these director-led appointments are creditor-driven as it is common that secured creditors invite directors to appoint to distance themselves. More about the appointment approach in administration, see Frisby, *A Preliminary Analysis of Pre-Packaged Administrations,* and J Armour, A W Hsu and A Walters, The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK (2008) 5 *European Company and Financial Law Review* 148.

[48] Walton and Umfreville's study of Pre-packs found that marketing began prior to the IPs' involvement in over a third of all cases where any marketing was carried out. See P Walton and C Umfreville, *Pre-pack Empirical Research: Characteristic and Outcome Analysis of Pre-pack Administration* (Report to Graham Review, April 2014), 21.

[49] See G Akerlof, 'The Market for Lemons: Quality Uncertainty and the Market Mechanism' (1970) 84 *The Quarterly Journal of Economics* 488.

good assets in order to avoid losing money from the acquisition of potentially bad assets.

2. The Section 363 Sales in the USA Chapter 11 process

(a) The Mechanics of Section 363 Sales

The US Bankruptcy Code provides two separate and distinct sets of provisions under which a Chapter 11 Debtor in Possession ("DIP") or trustee may sell property free and clear of claims or interests.[50] Section 1123(a)(5)(D) governs sales made as part of a plan of reorganization (hereafter referred as "in-plan sales").[51] As sales pursuant to s 1123(a)(5)(D) are accomplished in the context of a reorganization plan, they require a debtor to satisfy plan confirmation requirements, including approval of a disclosure statement and creditor acceptance by voting of applicable classes of creditors and a good faith requirement. Section 363 of the Bankruptcy Code governs sales within or outside the ordinary course of business of the debtor company; in particular, subsection 363(b) governs sales outside the ordinary course of business and prior to a reorganization plan.[52] Section 363(b) does not automatically permit the sale of all or substantially all assets of the debtor's estate in a Chapter 11 reorganization. However, the courts have acknowledged that this restriction is subject to exceptions, especially where a particular case demonstrates the necessity of the sale to serve the best interests of the estate, and where imposition of strict rules for authorization of asset

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[50] Asset sales can take place either prior to any bankruptcy petition or during the bankruptcy procedure. Sales outside of bankruptcy can be challenged under state law as fraudulent conveyances when creditors think the sale price is inadequate. Critically the risks of fraudulent conveyance are eliminated when the asset sale is conducted under bankruptcy court supervision, since s 548 of the US Bankruptcy Code, which grants the trustee the power to avoid fraudulent transfers, applies only to pre-petition transfers.

[51] Pursuant to s 11232(a)(5)(D) US Bankruptcy Code, a company may implement a reorganization plan through the "sale of all or any part of the property of the estate." Further, section 1123(b)(4) provides that "a plan may . . . provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests."

[52] Section 363 grants the trustee or DIP the right to use, sell, or lease property of the estate under certain conditions. There is no clear test for determining when a sale is in the "ordinary course of business". However, two tests have been developed under the case law: the "vertical dimension" test under which the court focuses on the specific transaction and determines whether it is of a type that the parties in interest reasonably expect the debtor to conduct in ordinary course of its business and the "horizontal dimension" test where the court focuses on a comparison between the debtor's business and businesses in the same industry to determine whether the proposed transaction is in the ordinary course of such business. See SD Consins, 'Chapter 11 Asset Sales' (2002) 27 *Delaware Journal of Corporate Law* 835, 841-42.

sales may prevent parties from acting quickly, resulting in an adverse impact on the value of the assets concerned.[53]

When the company is operating under Chapter 11 protection, typically, the debtor will enter into an asset purchase agreement with a pre-selected buyer known as a 'stalking horse' bidder and the agreement will be presented to the court for its approval. Once the process and bidding procedures have been approved to enable other potential purchasers to submit bids, other bidders may appear forcing an auction.[54] After the completion of the auction, the bankruptcy court will conduct a hearing to consider whether the sale to the successful bidder (normally the one that provides the highest purchase price or total consideration) should be approved.

In terms of the procedural requirements for 363(b) sales, the Bankruptcy Rule 2002(a)(2) requires that notice is given to all interested parties before the proposed sale. Courts generally permit debtors to shorten the notice period based on the exigencies of a particular case provided that the reduced notice period is sufficient to ensure that all interested buyers have an opportunity to bid for the assets.[55] Individual creditors, creditor committees, United States Trustees, as well as potential buyers, can object to proposed sales and bidding procedures under the Bankruptcy Rule 6004(b). Beyond the Federal Rules, there are local bankruptcy rules made by district courts providing court-specific procedural rules governing proposed s 363 sales to help streamline proceedings.[56]

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[53] The Second Circuit in *In re Lionel Corp*. 722 F.2d 1063 (2d Cir. 1983) noted that "the bankruptcy machinery should not straightjacket the bankruptcy judge so as to prevent him from doing what is best for the estate." It was acknowledged that the likelihood of maximizing value for one debtor may necessitate a different method for another. Therefore, the court affirmed that "to further the purposes of Chapter 11 reorganization, a bankruptcy judge must have substantial freedom to tailor his order to meet differing circumstances". See 772 F.2d at 1069.

[54] S Gilson *et al*, 'Cashing Out: The Rise of M&A in Bankruptcy' 2015 Harvard Business School Working Paper 15-057.

[55] RM Fishman and GE Gouveia, 'What's Driving Section 363 Sales after Chrysler and General Motors?' (2010) 19 *Norton Journal of Bankruptcy Law and Practice* 351, 355.

[56] Each district court acting by a simple majority of its district judges may make and amend rules governing practice and procedure in all cases and proceedings within the district courts' bankruptcy jurisdiction subject to relevant Acts of Congress. Local rules often provide greater detail about such issues as to who must receive notice; how long before a hearing notice must be given; how objections can be made; how public versus private sales will be conducted; and which connections, relationships,

Once a Section 363 sale has been consummated and the buyer pays the agreed consideration, the proceeds of a s 363 sale become property of the distressed firm that can be used to satisfy the claims of its creditors.[57] Apart from any claims or liabilities assumed by the buyer, any other outstanding claims against the company remain in the company, subject to satisfaction through the reorganization plan.[58] Until the court has approved (or "crammed down") the reorganization plan, the company remains under bankruptcy protection.

Conducting a s 363(b) sale prior to the confirmation of Chapter 11 plan speeds up the conclusion of the process and there are good reasons premised on business efficacy to justify this shift, especially where there is a clear and imminent danger that the value of the company or its assets will diminish the longer it stays within the Chapter 11 process, so-called "ice-cube" effect. On the other hand, there are serious concerns that the expedited chapter 11 process relies too heavily on asset sales and plans negotiated prior to bankruptcy.[59] The latter is a very important development, because the terms or the effect of a pre-plan transaction may subvert the protections of Chapter 11, undermining the procedural value of the statutory regime.

Section 363, in theory, provides just a formal mechanism through which the debtor (or appointed chapter 11 trustee), upon approval by the court, can sell all, or a portion of, the entity's assets to a third party before achieving acceptance by the creditors of the plan of reorganization.[60] It is not tantamount to a *de facto* reorganization plan. A reorganization plan is much more comprehensive than a s 363 sale. It has to address the overall financial situation of the entity and the effects of its plan on creditors when it emerges from bankruptcy. But, the approval of a section 363 sale of all or of a

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and compensation must be disclosed, etc. See JA Wilkerson, 'Defending the Current State of Section 363 Sales' (2012) 86 *American Bankruptcy Law Journal* 591, 597.

[57] The buyer will obtain title to the purchased assets free and clear of any prior liens and claims, as well as any claims or liabilities assumed by the buyer.

[58] Like in-plan sales under s 1123 via 1141(c), s 363(b) transactions are "free and clear of all claims and interests of creditors" via s 363(f).

[59] See Baird and Rasmussen, 'The End of Bankruptcy', 786-8; Baird, 'Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations'.

[60] Sales within the ordinary course of business of the debtor are governed by s 363(a), where prior notice to creditors or an opportunity for a hearing is not required (s 363(c)(1) US Bankruptcy Code). But sales outside the ordinary course of business governed by s 363(b) are subject to certain level of scrutiny from creditors and the bankruptcy court.

substantial portion of an entity's assets inevitably has a significant impact on the determination of important issues that would ordinarily be addressed as part of the reorganization plan.

There is a *sub rosa*[61] prohibition in common law to prevent a proposed s 363 sale from functioning as a *de facto* reorganization plan. The doctrine restricts the permissibility of a transaction or agreement which commits such a substantial part of the debtor's assets that it would *de facto* predetermine the terms of a reorganization plan, dictate the terms of a plan, or otherwise restructure creditors' rights.[62] Nevertheless, in US courts' more recent jurisprudence on the *sub rosa* issue[63] offers only a loose standard for the determination of the *sub rosa* prohibition and most s. 363(b) transactions have been allowed to proceed.[64] Yet, it has been made clear that the sale of all or substantially all of debtors' assets via s 363(b) could in itself dictate the terms of a subsequent plan.[65] The bottom line here is whether the terms of the sale constitute an attempt by the debtor to circumvent the distribution scheme of the Bankruptcy Code, in other words, whether the terms for the allocation and/or distribution of the sale proceeds among creditors and equity holders is contrary to the Code's priority scheme.[66]

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[61] The Latin phrase *sub rosa* here means "confidential, secret, not for publication." The reach of this restriction was exemplified by the Fifth Circuit of the US Court of Appeal's decision in *Pension Benefit Guar. Corp. v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*), 700 F.2d 935 (5th Cir. 1983)

[62] "The debtor and the Bankruptcy Court should not be able to short circuit the recruitments of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets." See *Pension Benefit Guar. Corp. v Braniff Airways, Inc*. (*In re Braniff Airways, Inc*.), 700 F.2d 935 at 940 (5th Cir. 1983)

[63] There was a *sub rosa* issue in this case: the s. 363(b) sale was contested by the Pension Trust on grounds that it constituted a *sub rosa*, and thus it amounted to a "secret plan" to reorganize *Chrysler*'s assets that should have been conducted within *Chrysler*s reorganization plan under Chapter 11 of the Code.

[64] A Karam, 'The Chrysler Bankruptcy and Future of 363(b) Transactions' (2011) XI *Houston Business and Tax Law Journal* 395, 425.

[65] The Second Circuit in the *Lionel* case pointed out that: "Every sale under s363(b) does not automatically short-circuit or side-step Chapter 11, nor are these two statutory provisions to be read as mutually exclusive." 722 F.2d at1071.

[66] See *In re Trans World Airlines, Inc.*, 2001 WL 1820326 at 11 (Bankr D Del Apr.2, 2001). An example can be the case *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007), where the Second Circuit held that a settlement in the course of bankruptcy proceedings was inappropriate because it distributed assets to prepetition creditors as part of the agreement and the settlement allowed the negotiating parties to sidestep the fair and equitable standard as well as the absolute priority rule of the bankruptcy plan confirmations. See 478 F.3d 453 at 462-65.

Said prohibition will not be easily applied to a going concern sale of a substantial part of the business as long as all the proceeds of the sale would be allotted to creditors according to the Chapter 11 priority scheme.[67] Furthermore, the mere fact that the terms of the sale lead to more favourable treatment of certain claimholders than other creditors in the same class or in a higher class is not considered as contrary to or undoubtedly restructuring the Code's priority scheme.[68]

The plan confirmation process is an important step in Chapter 11 proceedings as it introduces creditor scrutiny and DIP accountability. Plan confirmation is a relatively democratic process, since it requires a debtor to propose a reorganization plan and work with creditors to obtain their approval. Therefore, in-plan transactions under s 1123 provide a much greater level of participation and protection to creditors than does a s 363(b) sale. As part of the plan confirmation process, sales pursuant to s 1123 approval is subject on a constellation of requirements. For example, s 1125 sets out disclosure requirements[69] aiming to help claim-holders' evaluation of the proposed sales before voting. Also following claim-holders' approval the court will confirm the plan provided that it meets the comprehensive requirements of subsection s 1129(a) of the Code.[70]

This heavier degree of judicial scrutiny contrasts with the much lighter procedure for approval of s 363(b) transactions which only requires "notice and a hearing" before the bankruptcy judge. In addition, a s 363(b) pre-plan sale may be approved by bankruptcy courts without an actual hearing if the notice is given properly and if such a hearing is not requested in a timely manner by a party in interest or if there is

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[67] In Chrysler the court asserted that the proposed s. 363(b) transaction was not a *sub rosa* plan because the debtor would receive more than fair value in return for the sale of assets to *Fiat*, based on the valuation and the fact that *Fiat* was the only entity willing to help *Chrysler*, which otherwise might have been forced into a total liquidation, and all the sales proceeds would be distributed according to the Chapter 11 priority scheme. 405 B.R. at 97-98. Similarly, in GM, as regards the *sub rosa* accusation put forward by a group of bondholders, the court noted that since the proceeds of the sale would be allotted to creditors according to the Chapter 11 priority scheme. See 407 B.R. 463, at 481-82.

[68] The court in *Chrysler* stated that the executory contracts New *Chrysler* would take over through the sale did not violate the priority rules of a Chapter 11 plan, even though they received more favourable treatment than other creditors in the same class or in a higher class. 405 B.R. at 98-99.

[69] In-plan sales are subject to the s 1125 requirement of disclosure statements describing the terms and conditions of the plan to enable claimholders to make meaningful evaluation on the proposed sales.

[70] This requires among other things, that the sale is in the best interests of creditors and be accepted by all impaired classes of creditors, or that it has the support of at least one class of impaired creditors and it is fair and equitable.

insufficient time to hold a hearing before the sale is effected.[71] As regards court approval of s 363(b) sales, the statute itself provides no guidance about the kind of standards that courts are to apply for approving or disapproving the sale, notwithstanding the rigorous requirements of chapter 11 plan confirmation. Thus, the courts, in exercising discretionary power, have to mould their own views and try to balance the authority to sell all or a substantial part of the debtor's assets against the potential for abuse where the parties evade Chapter 11 safeguards. Therefore, the additional safeguard of plan confirmation is rendered redundant in the context of s. 363(b) sales.

(b) Judicial Scrutiny of s 363(b) Pre-plan Sales

Despite silence in the statute about the standards that courts should apply for approving a s. 363 sale, the Code gives bankruptcy judges broad equitable power to do what is necessary.[72] Certain guidelines have been established in case law on how to approach s. 363(b) transactions, although no court offered fixed or more concrete standards through which they can analyse these transactions, nor the Supreme Court has shown any intention to provide lower courts with a concrete set of standards.

The prevalent standard for court approval of s. 363(b) sales is the sound business justification standard,[73] articulated by the Second Circuit in *In re Lionel Corp.*[74] In this seminal decision, the court recognized the danger of "swallowing up chapter 11's safeguards" through the disposition of important assets under s 363(b) without a sound business justification. Thus, it held that there must be "a good business reason"

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[71] S 102(1)(b) US Bankruptcy Code.

[72] S 105(a) allows the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title … shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process." It should be noted that a bankruptcy court is not allowed to use s. 105(a) in contravention of express statutory language. See the U.S. Supreme Court's decision in *Law v. Siegel*, 134 S. Ct. 1188 (2014). The Supreme Court stated that it was "hornbook" law that § 105(a) "does not allow the bankruptcy court to override explicit mandates of other [Code] sections". (*Law v. Siegel*, 134 S. Ct. at 1195).

[73] Also known as "sound business purpose" or "business judgment".

[74] *Committee of Equity Security Holders v Lionel Corp*. (*In re Lionel Corp*.) 772 F. 2d 1063 (2d Cir. 1983) In this case, the debtor proposed to sell its most significant asset – 82 per cent of the common stock of its solvent, profitable, publicly traded subsidiary corporation. Four days after proposing the sale, the debtor filed a plan of reorganization that was conditioned on the pre-confirmation sale and the distribution of the sale proceeds to creditors.

for approval of the sale of substantial assets by the debtor outside of a reorganization plan.[75] To construe a good business reason, the Second Circuit instructed bankruptcy judges to consider a list of factors.[76] Amongst those factors the fluctuation of the value of the assets, as suggested by the Second Circuit, was the most important criterion to consider in determining the propriety of a proposed sale under s 363(b).[77]

Nevertheless, financially distressed companies have been increasingly looking to s 363(b) for a faster, less burdensome, and cheaper resolution to their financial ailments since the Second Circuit set forth its seminal decision in *Lionel* in 1983. In parallel with the increased number of sale approvals, there has been a movement away from the strict emergency and perishable goods rationales that were used to justify an urgent need to sell towards adopting a more liberal yet inconsistent application of the *Lionel* standards for approving s. 363 sales. This is exemplified in the Second Circuit's recent reconsideration of the s. 363 pre-plan sale in the *In re Chrysler LLC*[78] case and the approval of the 363(b) transaction in the *General Motors* ("*GM*") case[79]

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[75] The Second Circuit in determining whether to affirm the sale's authorization reasoned that "there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b)." The court held that The *Lionel* creditors' committee on the sale in this case did not constitute a sufficient business justification because: (a) as a matter of fact, there was no evidence that the sale could not be completed pursuant to a plan at the same price and (b) as a matter of law, as approval of the sale at the behest of the creditors' committee ignored the equity interests required to be weighted and considered under Chapter 11. See 722 F.2d 1063, at 1070-1071.

[76] Those factors include the proportionate value of the asset to the estate as a whole; the amount of time that has elapsed since the filing of the petition; the likelihood that a plan of reorganization will be proposed and confirmed in the near future; the effect of the proposed sale on a future plan of reorganization; the proceeds to be obtained from the dispositions *vis-à-vis* any appraisals of the property; which of the s 363 alternatives, use, sale, or lease, the proposal envisions; and most importantly, perhaps, whether the asset is increasing or decreasing in value. See 772 F. 2d 1063 at 1071.

[77] Whether the asset is increasing or decreasing in value was the determining criterion in establishing that there was no good business justification for the sale in this case because it was considered that the common stock that was the subject of the sale was not falling in value. See 772 F. 2d at 1071-1072. An example of such an urgent need to sell can be found in the case *In re Baldwin United Corp*, where the court considered that the sale of partnership interest constituting 40 per cent of debtor's assets articulated a sound business justification. It acknowledged that the nature of such interest would, if not sold promptly, only impede reorganization and would lose value as an asset in the long term. *In re Baldwin United Corp*., 43 B.R 888 (Bankr. S.D. Ohio 1984) at 905-06.

[78] *Ind. State Police Pension Trust v Chrysler LLC* (*In re Chrysler LLC*), 405 B.R. 84 (Bankr. S.D.N.Y. 2009) affirmed, 576 F.3d 108 (2d Cir. 2009). In this case secured creditors advanced one of the major objections to the proposed pre-plan sale: that the sale benefited certain unsecured creditors more than those with collateral. The Second Circuit in *In re Chrysler LLC* applied the *Lionel* business justification standard in approving the sale of substantially all of the assets of *Chrysler LLC* and its subsidiaries and upheld the bankruptcy court's approval of the sale of the company to *Fiat* over the objections of certain creditors.

[79] *In re General Motors Corp*., 407 B.R. 463 (Bankr. S.D.N.Y. 2009). In this case, GM proposed to sell

by the same bankruptcy court which heard *Chrysler*. Both *Chrysler* and *GM* arguably stretched the limit of what is permissible in traditional s 363 sales by justifying the urgent need to see on the basis of the costs of a lengthy formal procedure, fear of limited offers, and the looming effects of a total liquidation, instead of strictly immediate emergency.[80]

More recently in *In re Gulf Coast Oil Corp*.,[81] the Bankruptcy Court for the Southern District of Texas recognised that the evolving nature of s. 363 sales and the associated concerns that "the concept of debtor reorganization and rehabilitation is in peril"[82]. Without altering the essence of the sound business justification test established in *Lionel*, Judge Steen provided a nonexclusive list of factors that should be considered when determining whether to approve a 363(b) sale prior to confirmation of a Chapter 11 plan.[83] Said list integrated several new factors into the analysis, including considerations as to whether the proposed purchase agreement facilitates competing bids and whether the assets in question have been aggressively marketed in an active market.[84] Other considerations referred to the disinterestedness of the debtor's fiduciaries which necessarily involves an investigation into the underlying relationship between the debtor and the purchaser.

The key improvement in Judge Steen's updated guidelines is the emphasis on marketing efforts when judging the reasonableness of the purchase price, and a market test may to some extent dictate the fair value of the estate and prevent abuses

most of its assets to a government-sponsored buyer to whom it would also assign the health and welfare benefits of GMs employees. GM struck the agreement for the sale following government-sponsored attempts to restructure out of court. The US and Canadian Governments were the only entities willing to extend financing for the transaction, on the condition that such financing would be used within a six-week time period after which they would rescind the offer.

[80] Commentators have criticized the courts in *Chrysler* for permitting s 363 sales to be used as substitutes for reorganization and for denying creditors the right to actively negotiate to enhance their own interests. See DA Skeel Jr., 'Why the Chrysler Deal Would Horrify a New Dealer' (2009) American Enterprise Institute Scholar Posts < http://www.aei.org/publication/why-the-chrysler-deal-would-horrify-a-new-dealer/ > accessed 30 January 2018.

[81] *In re Gulf Coast Oil Corp*., 404 B.R. 407 (Bankr. S.D.Tex. 2009).

[82] 404 B.R. at 419.

[83] 404 B.R. at 422-427.

[84] See Fishman and Gouveia, 'What's Driving Section 363 Sales after Chrysler and General Motors?' (2010) 19 *Norton Journal of Bankruptcy Law and Practice* 351, 354.

that stem from undervaluation.[85] But still the speed of the s. 363(b) sale process will likely preclude an effective market test and the safeguards that the test ensures. Because the fast pace of s. 363(b) sales often requires that any competing bids be submitted within a matter of days this time limitation can predictably impede competitive market valuation of the assets.[86]

In general, recent modifications of the guidelines on how courts should exercise their discretionary power in approving s. 363(b) sales have not saved the application of judicial scrutiny from being criticized for being open to manipulation thus offering insufficient protection against possible abuse of s 363.[87] This happens because the business justifications presented by the bankruptcy courts generally center around saving time or money. Consequently parties can manipulate the courts' application of the principle of business justification by creating immediate necessity, which often serves as an overriding factor when weighing the potential misuses of s 363 sales.[88] As businesses struggle or approach failure, they have the ability to manufacture an emergency by delaying bankruptcy filings until the last possible moment,[89] since the hurdle to achieving a 363(b) sale is no more than a mere notice and a hearing. Yet the deal to sell can be so substantial that it often *de facto* dictates the core terms of the reorganization plan. This opens the door to abuse of the whole process. When they exercise their power to approve the s. 363(b) sale the courts essentially also verify the economic merits of the pre-plan sale. But the courts have not fashioned yet a makeshift safeguard as a sufficient substitute for the Chapter 11 plan safeguards (disclosure, voting, acceptance, and confirmation).

The recent case *In re Jevic Holding Corp.*[90] in a way reflects the Supreme Court's

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[85] Professor Barry E. Adler advocated putting all large s 363(b) sales through a stringent market test to ensure fair price and prevent abuse, see Oversight of TARP Assistance to the Automobile Industry: Field Hearing Before the Congressional Oversight Panel, 111th Cong. 97-108 (2009).

[86] AJ Warburton, 'Understanding the Bankruptcies of Chrysler and General Motors: a Primer' (2010) 60 *Syracuse Law Review* 531, 567.

[87] It has been argued, following both decisions, that the US courts applied inconsistently the business justification analysis established in the case of *In re Lionel*, relying on this principle only for factual comparisons. See K Korres, 'Bankrupting Bankruptcy: Circumventing Chapter 11 Protections Through Manipulation of the Business Justification Standard in s 363 Asset Sales, and a Refined Standard to Safeguard Against Abuse' (2013) 63 *Florida Law Review* 959, 971.

[88] *Ibid.*, 973.

[89] *Ibid.*, 974.

[90] *Czyzewski v. Jevic Holding Corp.*, 580 U.S. _(2017). This case concerned a settlement, implemented through a structured dismissal (a dismissal of the case together with an agreement to settle various

desire to limit bankruptcy courts' discretion and require the courts to be further bound to the specific provisions of the Bankruptcy Code. The Supreme Court held that the bankruptcy court could not order a structured dismissal that distributes estate assets in a manner that violates the Code's ordinary priority rules without the consent of creditors. [91] However, the Supreme Court carved out from its ruling some interim distributions. [92] In doing so, the Court distinguished cases in which courts have approved interim settlements resulting in distributions of estate assets in violation of priority rules, with nonconsensual violations in the context of a dismissal which amount to a *final* distribution of estate value.[93]

The issue of priority is a matter of contention in 363 sales and it is unclear to what extent the *Jevic* decision may affect the court's balancing of procedural efficiency and creditor protection. In particular, does the Supreme Court's rejection of the bankruptcy court's attempt to reach a resolution to address *Jevic*'s "dire circumstances", as there was no alternative, suggest that courts may take a more structured, rules driven approach in approving pre-plan sales rather than relying on equitable or "best under the circumstances" reasoning and subsequent distributions? Would such a shift make the *sub rosa* plan arguments more weighty?

The U.S. Court of Appeals for the First Circuit in its recent decision in *In re Old Cold LLC*[94] provided some indication that courts will limit *Jevic*'s reach in the context of

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issues), which provided distributions to *Jevic*'s secured creditors and general unsecured creditors but no distributions to certain priority employee claims.

[91] The Bankruptcy Court approved the settlement and dismissal over the objections of the wage claimants and the U.S. Trustee. The court recognized that the settlement and dismissal violated the ordinary priority rules of the Code, but held that, without the settlement and dismissal, there would be no meaningful distribution for any creditor, accordingly approval of the structured dismissal was appropriate. The District Court affirmed, holding the priority rules of the Code were "not a bar to the approval of the settlement as it is not a reorganization plan." The Third Circuit affirmed. But the Supreme Court reversed the judgement.

[92] Examples of such distributions include first-day wage orders and critical vendor orders that may violate priority rules but have value of preserving the debtor as a going concern.

[93] *An example is In re Iridium Operating LLC*, *the* Second Circuit's authorization of an *interim* distribution of settlement proceeds to fund a litigation trust that would press claims on the estate's behalf.

[94] *In re Old Cold LLC*, No. 16-9012, 2018 WL 387619 (1st Cir. Jan. 12, 2018). The chapter 11 debtor auctioned off substantially all of its assets pursuant to section 363(b) of the Bankruptcy Code. One of two bidders participated in the auction is Schleicher and Stebbins Hotels LLC ("S&S"), the stalking horse bidder, who was both a secured creditor and the majority stockholder of the Debtor. S&S was declared the winning bidder, with a bid providing for the payment of certain unsecured claims (i.e., the

363 sales, when it refused to apply *Jevic* to disturb an asset sale under section 363(b). One of the issues considered by the First Circuit was whether *Jevic*'s rationale should extend to a section 363(b) sale in *Old Cold*.[95] The First Circuit affirmed the bankruptcy court's authorization of a 363 sale suggesting that the ability of purchasers to assume junior debt (such as important vendors and suppliers) while leaving behind senior debt is an important feature of many 363 sales and any decision that would limit such ability could have had a severely negative impact on the use of 363 sales.[96]

D Addressing the tension between procedural efficiency and creditor protection

The accelerated approaches have reformulated the way in which assets are restructured or disposed in insolvency and shift the key function/utility of formal procedures from the traditional provision of a platform to adopt key decisions to a mere verification process.

Undeniably the pre-arranged sales are efficiency-enhancing, remedying the anti-commons problem that arises as result of the need for lengthy negotiations among heterogeneous creditors in the context of statutory proceedings. As shown in section C, there is a certain level of denial of (junior) creditor participation in both of the accelerated approaches to going concern sales in both countries. Let's suppose, the estate is subject to an ice-cube effect[97], then the only realistic way to maximize value and preserve the going concern surplus is to sell the business as a going concern as quickly as possible. Pre-arranged sales bypass the voting mechanism and narrow the range of potential bargaining. Thus, they minimize the likelihood of destruction of business value caused by potential strategic actions of certain creditors.

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prepetition unsecured debt assumed by S&S) before certain administrative claims.

[95] In particular, the propriety of the sale violated the priority rules in contravention of *Jevic* because the winning bidder provided for the payment of certain unsecured claims (i.e., the prepetition unsecured debt assumed by S&S) before certain administrative claims.

[96] The First Circuit rejected the argument that "*Jevic*'s enforcement of priority rules applies to all end-of-case distributions, including asset sales." *In re Old Cold LLC*, No. 16-9012, 2018 WL 387619 (1st Cir. Jan. 12, 2018) at 10.

[97] The term is used to metaphorize a distressed company as a melting ice cube to justify a quick sale soon after a formal procedure commences. See MB Jacoby and EJ Janger, 'Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy' (2014) 123 *Yale Law Journal* 862.

Nonetheless, the efficiency gains are achieved at the expense of creditor participation which is one of the fundamental safeguards of formal procedures. The pre-arranged sale route is therefore often criticized for undermining procedural inclusiveness which the law normally extends to most affected creditors. This development has intensified the tension between procedural efficiency and creditor protection, giving rise to a growing debate questioning whether the disenfranchisement of certain affected creditors is a proportionate trade-off to achieve procedural efficiency.

One the one hand, the efficiency-enhancing benefit in the pre-arranged sales is achieved by shifting more control to private parties (mainly incumbent management and key creditors) so that they act quickly in their strategic planning to prevent devaluation of business value.[98] On the other hand, with the present watering down of procedural safeguards, the shifting of control tends to create a vacuum over the quality of the business decision-making process. This is intensified by the inherent information asymmetries permeating any possible check on the exercise of private parties' discretionary power to fashion a rescue solution.

The key criticism as regards the efficacy of the accelerated sales path in the context of a formal procedure is that it entails increased risk of erroneous undervaluation caused by fast sales and the watering down of procedural safeguards. The combined effects of the need for speed and the constriction of creditor participation place great pressure on the quality of decision-making that leads to the sale deal, as the process is opaque, giving parties enormous discretion to pick winners and losers largely free of judicial checks and balances. Moreover, the short timeframe often works as a defensive strategy making it difficult to judge whether decisions have been made correctly. Therefore, the absence of workable checks over the exercise of private parties' discretionary power cannot be dismissed lightheartedly.

[98] This is supported by empirical research finding that DIP lenders play an important role in screening viable companies, and in monitoring and generating information on the prospects of firms in Chapter 11. See also FA Elayan and TO Meyer, 'The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and Time Spent Under Chapter 11 Bankruptcy', 28 *Journal of Business, Finance & Accounting* (2001) pp. 905-942. S Dahiya *et al*., 'Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence', 69 *Journal of Financial Economics* (2003) pp. 259-97.

There are two mechanisms that could potentially provide effective checks and controls in the case of accelerated sales in insolvency. One is to offer affected parties pre-view rights before concluding the pre-arranged sale, including the opportunity to file objections to the proposed sale, as an important means of safeguarding their interests. Another mechanism is enhancement of judicial scrutiny or of that exercised by insolvency professionals acting as authorized court-officers. The former mainly addresses concerns that the need for speed often leaves non-participating creditors with very little opportunity to evaluate the case and that the short timeframe limits the ability of potential investors to gather information and to bid. The latter is to ensure effective gatekeeping independent of party objection when assessing the merits of relevant business decisions.

1. Granting affected creditors a Pre-view right?

In the US, the Report of the ABI Commission in 2014 recommended a 60-day moratorium on sales of substantially all assets so as to create a "breathing spell" to afford parties in interest (and competing bidders) a reasonable period of time to assess the proposed sale, and also to explore a stand-alone reorganization or other restructuring alternatives. [99] Similarly in the UK, the entirely disenfranchised position of junior creditors in pre-pack sales has led to a key reform proposal in the draft of the Insolvency (Amendment) (No. 2) Rules 2011. This would have required administrators to give a three-day notice to creditors when they propose to sell a significant proportion of the assets of a company or its business to a connected party, in circumstances where there has been no open marketing of those assets.[100]

Nevertheless, both proposals were not adopted due to criticism as regards the direct and indirect costs associated with the 'breathing spell' where time matters as to the fluctuation of the value of the asset and the imminent need for additional financing

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[99] It further specified that the court should not shorten the 60-day moratorium unless the trustee or a party in interest "demonstrate[d] by clear and convincing evidence that there [was] a high likelihood that the value of the debtors' assets [would] decrease significantly" within those 60 days, and the court found that the proposed sale satisfied the standards set forth in the principles for section 363x sales. American Bankruptcy Institute, *Final Report of the ABI Commission to Study the Reform of Chapter 11* (2014) ("the ABI Commission Report") < https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h > accessed 30 May 2018, 83.

[100] See the Written Ministerial Statement on Pre-packaged Sales in Administrations (House of Commons Hansard Ministerial Statements on 31 March 2011, cm 29WS.

during the moratorium period.[101]

Naturally, when it comes to business sales, or in general, asset deployment, judgement on whether the deal maximizes value may be hard to formulate due to the inherent uncertainty regarding realizable value and ongoing commercial viability during the process. Determining the right course of action under various corporate rescue scenarios demands creativity, skills, judgment, anticipation, and taking into consideration of the uncertainty and impact.[102] It also involves consideration of a wide range of assumptions regarding future and counter-factual data.[103] This also means that decisions have to be judged in particular contexts and cannot be pre-ordained according to a fixed set of valuation rules. Accordingly, it makes sense to discuss asset deployment issues mostly in terms of the process through which such decisions are made. A review of the quality of the asset deployment decision itself will mainly rely on factors affecting the ability to obtain the best possible price such as timing, capacity of decision makers, ability to attract competing bids. If this is found to be flawed then some other course of action or valuation method could possibly be considered/taken into account. The combined introduction of an expedited review of process would add a layer of accountability in the process of pre-pack business sales for the following reasons.

First, it is arguable that the importance of creditor voting may have changed in the context of business sales that go to a direction different from rescuing the company. Company rescue and reorganization is essentially a hypothetical sale under Chapter 11, which intertwines the asset deployment and claimant entitlement issues.[104] In this

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[101] The ABI Commission Report's 60-days, has been criticized that it would likely only serve to harm secured creditors while providing little to no benefit to junior creditors given the need for additional financing during the moratorium period and the potential erosion of secured creditors' collateral value. See Chapman And Cutler LLP, 'Twin Daggers: Proposed 363(x) Amendments and Revisions to Adequate Protection Provisions Would Significantly Erode Secured Creditors' Recoveries' (Client Alert, January 2015). The UK's 3 day's notice period was abandoned because it was by insolvency professionals as too restrictive. Also because it would create a legal setting that could impede administrators from pursuing their statutory objectives expeditiously.

[102] Xie, *Comparative Insolvency Law: the Pre-pack Approach in Corporate Rescue*, 301.

[103] Decision-makers must consider not only the causes of the financial disaster and the likelihood that remedial measures will reverse the problems, but must also consider the economic value of a range of options. See CW Frost, 'Bankruptcy Redistributive Policies and the Limits of the Judicial process' 74 (1995) *North Carolina Law Review* 75, 79.

[104] DA Skeel, Jr, 'Markets, Courts, and the Brave New World of Bankruptcy Theory' (1993) *Wisconsin Law Review* 465, 473-74.

case, creditors' voting and approval is indispensable, indeed essential, to ensure due process and fundamental fairness as the reorganization plan is 'fairly' bargained and accepted, and to ensure sensible redistributive outcomes to be reached. In contrast, pre-arranged business sales replace the hypothetical sale with an actual sale which arguably separates the two issues. Namely, the pre-arranged sale focuses on the question of how assets are be deployed and not on how realizable value will be distributed, even though the efficacy of asset dispositions will affect the amount of value for distribution.

Secondly, an expedited review process is more effective than just granting affected creditors broader rights. To begin with creditors voting and approval has limited practical importance in ensuring a good price. There may be a practical difficulty in identifying the affected claimholders who would be eligible to vote, due to the uncertainty of the value of the ailing business. As a result broadening creditor rights would create another layer of controversy by giving certain creditors the power to influence the process where they have no direct financial interest in the outcome of the sale or any other possible options. Furthermore, with pre-arranged sales the decision to pursue a sale takes place at a time when it is hard to tell whether a quick sale would have a higher expected return than a possible reorganization. This question also underscores the mismatched incentives of the different classes of creditors. On the one hand, senior creditors have an incentive to sell the company in a quick sale even when reorganization has a higher expected return for the estate. Junior creditors, on the other, may have an incentive to block the quick sale in favor of a drawn-out reorganization even when the sale has the higher expected return for the estate. So, arguably, a creditors' pre-view right instead of expedited judicial scrutiny could introduce a reverted anti-common issue to the accelerated sales in insolvency.

2. Independent valuations to buttress court or administrator sanction and scrutiny

The pre-arranged sale approach may alleviate the common anti-commons problems in corporate restructuring with the needed flexibility in the process so that decisions could be made in a timely manner. At the same time it entails enormous pressure vis-à-vis the quality of commercial decision-making and the effectiveness of judicial verification of the economics of the pre-arranged sales. The accountability of the decision-making and enforcement institutions in this context becomes extremely important as they play a determining role in examining and verifying, in a speedy way, compliance with the pre-existing requirements, rather than being used as rubber-stabbing bodies.

UK law places its full faith with a neutral decision-making body, namely, the administrator. Nevertheless, UK pre-pack sales are not free from controversy due to the frequency of the phenomenon of business sales to connected parties. Lack of impartial monitoring of pre-packs in UK law creates a risk that pre-formal negotiations are carried out in a self-serving manner by insiders. Statement of Insolvency Practice 16 (SIP 16)[105] strives to ameliorate the concerns the concerns raised by pre-pack sales to connected parties. It focuses on enhancing transparency of the accelerated sale process through comprehensive *ex post* information disclosure requirements. Following the Graham Review into Prepack administrations in 2014, SIP 16 was further revised in 2015 requiring enhanced disclosures to creditors. Directors of the company concerned should be advised that any pre-administration marketing should comply with 'marketing essentials' and that any valuations should be carried out by appropriate independent valuers who hold adequate professional indemnity insurance. Nevertheless, non-compliance with this professional guidance standard is dealt with by the regulators of insolvency professionals as part of a possible disciplinary action and the use of independent valuers is neither mandatory nor particularly successful. The rigor of the insolvency professional regulators in detecting instances of abuse and dealing with them has been seriously doubted. Professional bodies discharging a dual role of promoting and, at the same time, regulating the profession may show no zeal in prosecuting and enforcing breaches of professional standards to protect outside stakeholders, notwithstanding some concerns about reputation preservation.

Lack of trust in the even-handedness of administrators and the current light touch regulatory approach in Britain necessitates some fresh thinking about the duties of

[105] SIP 16 is adopted by all the relevant professional regulatory bodies and has been revised twice since its introduction in 2009. The latest edition SIP 16 – Pre-packaged Sales in Administrations, was effective from 1 November 2015.

administrators in the case of connected pre-pack sales. In order to ensure a level playing field in the pre-packing process, one significant initiative has been the establishment of a Pre-pack Pool in 2015 as a response to recommendations made in the Graham Review into Prepack administrations in 2014. It offers an option to connected party purchasers before the sale to approach the Pool of experienced business people who can provide a level of independent scrutiny of connected party pre-pack sales.[106] The applicant will decide what material will be presented to the pool member to opine on. After scrutinizing the documents, the pool member will issue a statement. Regardless whether the resulting statement is negative or positive,[107] it will be referred to in the SIP 16 statement to the attention of the creditors. The Pool member will not issue reasons for its decision, the justification being that this would cause delay and increase costs. The pool member's decision is not subject to appeal.

The establishment of the Pool is a positive development, and its utility in enhancing scrutiny is obvious.[108] Yet the general effectiveness of the pool is limited. First of all, use of the Pool is voluntary, and it is merely available to use by connected party purchasers. In the first 14 months of operation the Pool has received 53 applications which equate to 28% of the total number of connected party pre-packs during the same period.[109] Moreover, the questionable adequacy of the material supplied to the pool member which serves as the basis of the statement may also cast questions on the credibility of the ensuing opinion.

Amid all these doubts about the current pre-pack process, the Small Business, Enterprise and Employment Act 2015 introduced a reserve power for the Secretary of

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[106] It was launched following the recommendations of the Graham Review of 'pre-pack' administrations.

[107] The Pool member can issue one of three opinions:

1. Nothing has been found to suggest that the grounds for the proposed pre-packaged sale are unreasonable;
2. The evidence provided has been limited in some areas, but otherwise nothing has been found to suggest that the grounds for the proposed pre-packaged sale are unreasonable; or
3. There is a lack of evidence to support a statement that the grounds for the proposed pre-packaged sale are reasonable.

[108] E.g. where the statement from the Pool member suggests that there is lack of sufficient evidence to support a pre-pack sale, then an administrator who decides to proceed with the sale regardless he/she may have to give a clear explanation as to why the sale took place in the SIP 16 statement.

[109] Pre-pack Pool Limited, *The Annual Review 2016* (1 November 2015 and 31 December 2016), polished in March 2007 https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack%20Pool%20Annual%20Review%202016-17.pdf accessed 30 May 2018.

State making it possible to create regulations to either prohibit administration sales to connected parties or to impose conditions or requirements to allow a connected party sale to proceed.[110] This power lapses five years after commencement and it would only be exercised if the guidance in the newly released SIP 16 and the Pre-Pack Pool prove to be unsuccessful in containing the most controversial aspects of pre-pack sales.

There is mounting evidence that the application of SIP 16 has not closed most of the discussed loopholes. Empirical research suggests that, while independent valuations have been conducted in the majority of pre-pack cases, the quality of valuations is very poor; many were simply desk-top valuations and the valuation did not include all of the available assets, e.g. intellectual property or goodwill.[111] Similarly, the valuation methods used by independent valuers are rarely explained.[112] As a result, creditors often find administrators' reports to be no more than a compliance checklist inadequate to address creditors' legitimate questions on whether sales are proceeding more quickly than is necessary. This is of course a key value question since unnecessary speed can potentially reduce the value available to creditors, especially where a robust auction process has been eschewed or other restructuring alternatives have not been explored.

The most important concern is of course value maximization since the best way to enhance the fairness of payment allocations is to maximize the realized value of the business or of the asset pool to be disposed of. But optimization of going concern surplus may not be achieved by selling the business prematurely or exploration of other restructuring alternatives. To justify an accelerated sale in this case, two criteria must be considered: First, the urgency of the sale, for example where a delay to sell

[110] Section 129 of Small Business, Enterprise and Employment Act 2015. The power to make regulations will enable the Secretary of State to:
i. prohibit sales.
ii. allow sales to take place subject to the imposition of restrictions or conditions.
iii. provide for the requirement to obtain approval from the court, the creditors of the company, or other person of a description specified in the regulations.

[111] See P Walton and C Umfreville, *Pre-pack Empirical Research: Characteristic and Outcome Analysis of Pre-pack Administration*. An independent valuation was conducted in the overwhelming majority (91%) of cases surveyed.

[112] *Ibid.*, 84.

may lead to lower offers. Secondly, the offered price must be a fair price at the time; you cannot just sell at any price, especially if a set of recent circumstances have impaired market expectations of value.[113] The starting point must be the actual current value of the company, namely, its going concern value, since the proposed sale is a going concern sale. Once that value had been determined it would become possible to ascertain whether it is a fair value.

But judges and administrators are not expert valuers of business assets and business sales. It is therefore essential to equip the courts or the administrators with an expansive and timely valuation conducted by independent expert valuers in order to perform the verification tasks enhancing the legitimacy of the process and the choice of fast-tracked sales.

For this reason and in order to avoid stricter restrictions of connected party pre-pack sales in the future, I argue here that the current regulatory framework should be modified to add a staggered element of accountability that makes independent valuations for sales above a certain value mandatory. The threshold may be objective, for instance when individual assets of more than 1 million in value are disposed of or when an entire business is sold for 5 million. An expansive independent valuation could be costly and makes sense from a cost-benefit analysis point of view only with respect to higher value transactions where more is at stake in terms of creditor losses and general economic welfare. Moreover, the pool of assets in such cases would be substantial allowing the pool to bear the cost of hiring an outside expert. While this threshold is somewhat arbitrary it is beyond question that the bigger the business and higher the value of the transaction the higher the costs generated by undervalued business sales. Moreover, the parties would be more willing to incur the cost of obtaining an independent valuation if the prospect of losses by an undervalued sale is higher.

[113] E.g., the business might have suffered recent distress which, predictably, has sent a negative signal to the market limiting the number of potential purchasers or interested buyers make lower offers.

Alternatively, instead of numerical thresholds independent valuations may be mandatorily required in those cases where the market has not been properly tested or the marketing was done in a perfunctory manner.[114] Independent valuations may prove particularly useful where, in particular, it is claimed that a true auction and competitive sale proceedings were impractical and there was no free access to information to establish the fairness of the sale price or adequate time to generate competing bids.

In both cases the valuation methods and benchmarks used should be as close as possible to "market value". To add further credibility, historical data and comparative market and industry data about the value of similar businesses should be evaluated, where that is possible. In this context, the subject matter of the business, its location and client base, and sales growth in the relevant industry should also be examined. If time limits cannot permit comprehensive independent evaluation, the valuation report should identify the assets that were excluded from the valuations and all other limitations.

Further research is required to investigate the cost of substantive independent valuations and to understand the effect of valuation on the course of decision making. Relevant costs include direct expenditure like the cost of obtaining expert valuers and indirect costs (i.e. for disturbing the finality of the sale and bringing further complication that may disincentivise potential purchasers).

There are several other arguments mitigating in favour of mandatory independent valuations for sales above a certain threshold or for sales with procedural weaknesses. First, the cost of a substantive independent valuation may be set off by incentivising exploration of alternative courses of action that would maximize the value of pre-arranged sales. Secondly, it would augment the quality of court or administrator scrutiny as it would be the foundation of their judgement about the reasonableness of the offered price. Third, it gives creditors, especially junior creditors, an insight into objectivity of the decision making process ameliorating widespread information asymmetries that currently plague the accelerated process and enhancing its

[114] Namely, there was minimal advertising, and little efforts are made to identify potential purchasers.

legitimacy on both sides of the Atlantic. By sacrificing a minimum of procedural efficiency the recommended amendments reverse, to some extent, junior creditor disenfranchisement, and may protect administrators from the rising tide of creditor complaints.

The US regime operates on the debtor-in-possession principle, at the same time, deploys much intervention from the bankruptcy courts. Yet it is similarly short of requisite safeguards when it comes to the plaited approach. With US 363 sales, the law requires the proposed sales to be authorized by bankruptcy courts by exercising judicial discretion. To counteract recent concerns, the case law has been evolving in providing effective guidelines for in distinguishing permissible s 363 pre-plan sales from those that open the bankruptcy process to potential abuse. Nevertheless, in the absence of a negotiated resolution between all affected claimholders, the courts are left to stand astride complex valuation disputes, since bankruptcy court approval of a sale becomes the last scrutinizing measure before its completion. This move, however, not only runs counter to the trend away from substantive judicial review of the business merits of particular transactions, but may also assign to the courts an uncomfortable role. This new function is different from their traditional role of ensuring that legislative standards have been complied with in the negotiation and decision-making process. Essentially, it begs the old question- are courts really better placed to tackle the issues and meet the challenges involved in matters of commercial judgment? At the same time, it has been said that bankruptcy judges are powerless to assume the responsibility of preventing inadequate-price sales, because they can only act on information and transactions that are presented to them.[115]

The US courts could also incorporate in the existing framework a similar requirement for a credible expert opinion when sanctioning a business sale under s. 363, where: (a) the value of the company exceeds 5 million dollars, or (b) the value of the assets to be disposed is over 1 million dollars, and (c) where the deal presents procedural defects.

[115] It is concerned that managers' informational advantages coupled with their control over the initiation of business decisions may allow them to manipulate the decision making apparatus to their benefit. See CW Frost, 'The Theory, Reality and Pragmatism Corporate Governance in Bankruptcy Reorganization', at 114 and BL Zaretsky, Trustees and Examiners in Chapter 11, (1993) 44 *South Carolina Law Review* 907, 914.

American Judges would be able to use this opinion as an additional basis for their decision in addition to the parties' filings. At the very least this process will insert another level of control in the case that the business to be disposed of is grossly undervalued curbing at least the most egregious of abuses in the accelerated sales process without aggravating the commons anti-commons problem.

One may rightly question the necessity of this extra layer of valuation on the basis of a cost benefit analysis given many s.363 sales involve identification of an initial bidder, known as the stalking horse, and are possibly followed by an auction procedure. It is true a robust auction process is most efficient in minimizing opportunism in the process and in establishing a fair market price for the business that can then be used by the bankruptcy court for evaluation of various alternatives. This assumption is however challenged in the context of quick 363(b) sales. One obvious reason is that the short timeframe limits the ability of other bidders to gather information or participate in the process.

Furthermore, the auction process is costly for potential bidders, especially in the case of insolvency of large public companies, as they are difficult and expensive to evaluate.[116] To overcome the cost of losing the bid, the debtors often offer bidding incentives to a stalking horse with breakup fees if they were outbid. These incentives would likely attract stalking horses who would not otherwise have bid, making it even more difficult for second bidders.[117] The rarity with which stalking horses are displaced makes apparent that, in the absence of effective court oversight, the sale process is vulnerable to subversion.

The difficult task for the court is to minimize the uncertainties associated with the essential validity of the business so as to balance the interests of protecting creditor rights without sacrificing the most attractive aspect of pre-plan sales- speed. Bankruptcy courts should endeavor to minimize erroneous deprivation/ trading off between procedural efficiency and creditor protection if this becomes unavoidable. There is no practical principle to guide such an exercise. Perhaps insisting on an optimal solution for the debtor and avoiding undervalued sales in all cases is a fool's

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[116] LM LoPucki and JW Doherty, 'Bankruptcy Fire Sales' (2007) 106 *Michigan Law Review* 1, 41.
[117] *Ibid.* 41-2. LoPucki and Doherty's empirical research suggests that second bidders appeared in only 35% of the cases surveyed and were successful in only 17% of those cases.

errand. The most we can expect is the system being able to detect and prevent the cases where the potential harm to the business value from a quick sale pushed through by opportunistic use of the time urgency argument. Therefore, issues of valuation are at the heart of the adequate protection determination.

Much of course will depend on the integrity and the professional competence of the valuers who would be assumed to have strong expertise in distressed business transactions. While all observed problems with private gatekeepers would still apply here, the fact that the valuer is paid by the pool of creditors secures relevant independence from the parties connected to the sale and impartiality of professional judgement. The rationale is not dissimilar with that underlying the UK and US Corporate statutes and stock exchange regulations making compulsory the engagement of independent auditors in the scrutiny and verification of public companies' accounts. In addition, one would expect that independent valuers would be governed by the same strict professional standards as corporate auditors. Either way the proposals offered here do not require any creditor initiative and thus they still restrict the room for creditor's strategic behavior, while at the same time they significantly level the playing field between insiders and junior creditors.

E Conclusion

Value realization by way of pre-arranged business sales under the formal procedure can be implemented and consummated more quickly and at far lower cost than a sale done as part of the formal procedure. Although the process adopted by each jurisdiction is different, the popularity of pre-arranged business sales in the two countries under consideration suggests that the accelerated sales path through a formal procedure increasingly serves as the preferred option of resolving corporate distress. On the one hand, the accelerated approach permits the timely disposal of the failing business, serving as an economically efficient mechanism for the preservation of the going concern value of an ailing business. On the other hand, the accelerated approach to business sales in insolvency enables certain parties to customize statutory procedures in a way that upsets, to some extent, the balance between the debtor and some creditors. It, also, tends to shift the key properties of the statutory procedures from creditor coordination and plan formulation towards verification of pre-arranged transactions. In doing so it creates a vacuum of control over the quality of the business decision–making and eliminates the inclusiveness of the statutory procedure leaving ample room for rent-seeking by insiders and repeat players. Allegations of erroneous undervaluations caused by fast sales undermine the legitimacy of the entire process.

To mitigate these deficiencies, the law requires a system of controls that minimizes opportunistic behavior and prevents stakeholders from exploiting the insolvency process to create value-destroying opportunities or to capture value from other stakeholders. Action must be taken to reduce both the likelihood and efficacy of strategic behavior. As we discussed above, although the answer at this stage should be close scrutiny rather than imposing substantive regulation of accelerated business sales, a more rigorous incremental progress in ensuring tight scrutiny and accountability of connected party accelerated sales is very much needed. This, as argued in the article, requires a more responsive approach by the enforcement institutions, either administrators or the bankruptcy courts, especially in substituting the market test with independent expert scrutiny. The staggered approach to augment independent scrutiny, as proposed here, would equip the courts and/or the administrators with the required tools to perform the verification tasks assigned to them with enhanced competency and vigour. It would also substantially improve the legitimacy of the accelerated business approach without harming the business efficacy goals attached to this procedure.